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August 13, 2003

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Securities and Exchange Commission
450 Fifth Street, N.W.
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Re: Public Statement by SEC Official: Letter dated July 23, 2003 Regarding Washington State Bar Association's Proposed Opinion on the Effect of the SEC's Attorney Conduct Rules ("**Public Statement**")

Dear Mr. Prezioso:

We are writing to comment on the Public Statement. These comments are provided on behalf of the Corporations Committee (the "**Committee**") of the Business Law Section of the State Bar of California (the "**Business Law Section**"). The Committee is comprised of attorneys regularly engaged in the business of advising business enterprises, including "issuers" as defined in Rule 205.2(g) of the Securities and Exchange Commission (the "**SEC**"). The Business Law Section previously has submitted comments to the SEC with respect to its proposed rules under Section 307 of the Sarbanes-Oxley Act of 2002, Public Law 107-204, (the "**Sarbanes-Oxley Act**").[1] The Committee is writing because the Public Statement raises significant issues for California attorneys and their clients.

The Public Statement sets forth three positions of the Securities and Exchange Commission (the "**SEC**").

1. The SEC's recently adopted Rule 205.3(d) supercedes state laws or rules of conduct that prohibit disclosure of client confidences.[2]

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[1] Letters dated December 16, 2002 and April 7, 2003.

[2] Rule 205.3(d) permits an attorney appearing and practicing before the SEC in the representation of an issuer to reveal to the SEC, without the client's consent, confidential information related to the representation to the extent the "attorney reasonably believes necessary."

2. Rule 205.6(c) will shield an attorney from discipline or liability when he or she complies in good faith with the SEC's attorney conduct rules.

3. State bar disciplinary authorities may not even institute disciplinary hearings with respect to matters covered by the SEC's attorney conduct rules.

As discussed in this letter:

- California law and rules of professional conduct do prohibit lawyers from disclosing client confidences;
- The ability of clients to confer fully with their attorneys without fear of disclosure is an essential element of our judicial system;
- Disclosure of client confidences can have serious consequences for both the client and the attorney;
- It is unclear whether the SEC had the authority to adopt Rules 205.3(d) and 205.6(c) or that either of those rules preempt state laws and rules; and
- The State Bar of California has no power to refuse to enforce California statutes on the basis of federal preemption unless an appellate court has so ruled.

1. **California Law Requires Attorneys to Protect Client Confidences.**

The duty of a California attorney to maintain client confidences is clear and unambiguous. It is rooted in both California's statutory law and the Rules of Professional Conduct ("**California Rules of Conduct**").

California's State Bar Act provides that it is the duty of an attorney to "maintain inviolate the confidence, and *at every peril* to himself or herself to preserve the secrets, of his or her client." California Business and Professions Code Section 6068(e) (emphasis added). This duty applies to corporations as well as individuals. *Goldstein v. Lees*, 46 Cal. App. 3d 614, 621 (1974).

Clients also have a narrower, but no less important, right under California law to prevent another from disclosing a confidential communication between the client and lawyer. California Evidence Code Section 954.

Finally, Subsections (B) and (C) of Rule 3-600 of the California Rules of Conduct recognize the paramount duty of a California attorney:

> (B) If a member acting on behalf of an organization knows that an actual or apparent agent of the organization acts or intends or refuses to act in a manner that is or may be a violation of law reasonably imputable to the organization, or in a manner which is likely to result in substantial injury to the organization, *the member shall not violate his or her duty of protecting all confidential information as provided in Business and Professions Code section 6068, subdivision (e).*

> Subject to Business and Professions Code section 6068, subdivision (e), the member may take such actions as appear to the member to be in the best lawful interest of the organization. Such actions may include among others:
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> (1) Urging reconsideration of the matter while explaining its likely consequences to the organization; or
> (2) Referring the matter to the next higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest internal authority that can act on behalf of the organization.
>
> (C) If, despite the member's actions in accordance with paragraph (B), the highest authority that can act on behalf of an organization insists upon action or a refusal to act that is a violation of law and is likely to result in substantial injury to the organization, the member's response is limited to the member's right, and, where appropriate, duty to resign in accordance with rule 3-700.

The Committee further notes that the federal district courts in California have expressly adopted California's standards of professional conduct. Thus, attorneys appearing and practicing before these federal courts are obligated to comply with California's rules regarding the protection of client confidences. For example, Local Rule No. 83-3.1.2 of the United States District Court for the Central District of California provides:

> In order to maintain the effective administration of justice and the integrity of the Court, each attorney shall be familiar with and comply with the standards of professional conduct required of members of the State Bar of California and contained in the State Bar Act, the Rules of Professional Conduct of the State Bar of California, and the decisions of any court applicable thereto. *These statutes, rules and decisions are hereby adopted as the standards of professional conduct*, and any breach or violation thereof may be the basis for the imposition of discipline. The Model Rules of Professional Conduct of the American Bar Association may be considered as guidance.

See also L.R. 83-180(e) (Eastern District); Civil L.R. 11-4(a)(1) (Northern District); and CivLR 83.4(b) (Southern District).

2. <u>Protection of client confidences is essential to our legal system</u>.

The Committee recognizes that lawyers in private practice can play a unique and often pivotal role under the federal securities laws. Nonetheless, that role does not make private attorneys an adjunct to the SEC in enforcing those laws.[3] Indeed, the Committee believes that our adversarial system of justice will not work unless attorneys can act as independent advocates and advisers to their clients. The importance of the assistance of counsel is grounded on common law principles and reflected in the Sixth Amendment to

[3] Keating, Muething & Klekamp, 47 SEC 95, 109 (1979) (dissenting opinion of Commissioner Roberta S. Karmel).

the U.S. Constitution (as to criminal trials) and the Administrative Procedure Act.[4] When an agency with enforcement authority, such as the SEC, promulgates rules that weaken the confidential and fiduciary relationship between counsel and client, the agency necessarily interferes with the attorney-client relationship and the client's right to effective assistance of counsel.

If lawyers are not legally obligated to keep their clients' confidences confidential, it only stands to reason that clients will "mind their tongues" when seeking advice and counsel. When full and frank discussion is curbed, the lawyer may not be able to provide the right advice or defend his or her client adequately. As noted by the California Supreme Court:

> Protecting the confidentiality of communications between attorney and client is fundamental to our legal system. The attorney-client privilege is a hallmark of our jurisprudence that furthers the public policy of ensuring " 'the right of every person to freely and fully confer and confide in one having knowledge of the law, and skilled in its practice, in order that the former may have adequate advice and a proper defense.' [Citation]" (*Mitchell v. Superior Court* (1984) 37 Cal.3d 591, 599 [208 Cal.Rptr. 886, 691 P.2d 642].)

People ex rel. Dept. of Corporations v. SpeeDee Oil Change Systems, Inc., 20 Cal. 4th 1135, 1146 (1999).

As also stated by the California Supreme Court, the Committee believes that the same public policies apply to corporate clients:

> Certainly the public policy behind the attorney-client privilege requires that an artificial person be given equal opportunity with a natural person to communicate with its attorney, within the professional relationship, without fear that its communication will be made public. As one writer has said, 'The more deeply one is convinced of the social necessity of permitting corporations to consult frankly and privately with their legal advisers, the more willing one should be to accord them a flexible and generous protection.'"

D.I. Chadbourne, Inc. v. Superior Court, 60 Cal. 2d 723, 736 (1964), quoting Simon, *The Attorney-Client Privilege as applied to Corporations* 65 Yale L. J. 953, 990 (1956).

3. <u>Disclosure of Client Confidences Could Adversely Affect both Client and Attorney</u>.

The Committee recognizes that the Public Statement reflects the SEC's position that Rule 205.6 should immunize lawyers against discipline or liability when they act in good faith. However, the Committee notes that the SEC's attorney conduct rules were only very recently adopted and have yet to be tested in court. Moreover, the most controversial proposed rules, those relating to mandatory disclosures, have not yet been adopted.

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[4] 5 U.S.C. § 555(b) ("A person compelled to appear in person before an agency or representative thereof is entitled to be accompanied, represented, and advised by counsel or, if permitted by the agency, by other qualified representative.")

Therefore, the Committee believes that it is important to recognize that clients and lawyers could be severely harmed if lawyers rely on the SEC's assurances, however well-intentioned, that good faith disclosures of client confidences will be immunized, but courts ultimately rule that the positions taken in the SEC's Public Statement are incorrect.[5]

An attorney who violates the Business and Professions Code Section 6068(e) is subject to discipline by the California State Bar and may incur liability to the client whose confidences have been violated. Such discipline could be imposed either at the state level or at the federal district courts in which the attorney is admitted to practice. There is no "good faith" exception under Section 6068(e) of California's Business and Professions Code.

From a client's perspective, the disclosure of confidential information, including information protected by the attorney-client privilege, could have devastating effects. The risk of waiving the attorney-client privilege through the attorney's selective disclosure to the SEC is high and may result in the information becoming available in civil or criminal proceedings.[6] Indeed, this risk has been acknowledged by the SEC's Director of Enforcement: "a person who produces privileged or otherwise protected material to the Commission runs a risk that a third party, such as an adversary in private litigation, could obtain that information by successfully arguing that the production to the Commission constituted a waiver of the privilege or protection. This situation creates a substantial disincentive for anyone who might otherwise consider providing protected information."[7]

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[5]In declining to adopt the "selective waiver" provisions originally proposed by the staff, the SEC noted these very concerns:

> The Commission is mindful of the concern that some courts might not adopt the Commission's analysis of this issue, and that this could lead to adverse consequences for the attorneys and issuers who disclose information to the Commission pursuant to a confidentiality agreement, believing that the evidentiary protections accorded that information remain preserved.

SEC Release Nos. 33-8185, 34-47276, and IC-25919.

[6]The Committee notes that the questions concerning the application of the attorney-client privilege are likely to be complex as they could arise in a number of different contexts and jurisdictions.

[7]Testimony of Stephen M. Cutler, Director, Division of Enforcement, Before the House Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises, Committee on Financial Services, Feb. 26, 2003, at 9.

4. Substantial Questions Exist Regarding the SEC's Authority to Adopt Rules 205.3(d) and Rule 205.6(c) or to Preempt State Bar Disciplinary Standards.

The Committee believes that the authority of the SEC to adopt either Rule 205.3(d) or Rule 205.6(c) is likely to be challenged. An attorney faced with choosing between potentially irreparable harm to a client's interests arising from disclosure of a confidence or the cost of a good faith, well founded objection to the SEC's rules is virtually duty-bound to select the latter. As the Committee has previously articulated, one significant potential basis of the challenge will be that there is no evidence of Congressional intent to preempt state ethics rules. Because the rules have only been recently adopted and become effective, the outcome of any such challenges remains to be seen. However, the Committee notes that in other instances, courts have struck down SEC rulemaking for lack of authority.[8]

In adopting the final rules, the SEC cites as authority the following statutory provisions: Sections 3, 307, and 404 of the Sarbanes-Oxley Act; Section 19 of the Securities Act of 1933; Sections 3(b), 4(C), 13 and 23 of the Securities Exchange Act of 1934, Sections 38 and 39 of the Investment Company Act of 1940, and Section 211 of the Investment Advisers Act of 1940. These statutes do not appear to address Congressional intent to invest the SEC with broad authority to permit lawyers to disclose client secrets and then immunize or otherwise protect those lawyers who do.[9] As explained by the United States Supreme Court, an administrative agency, such as the SEC, does not have the authority to make laws – it has only the "power to adopt regulations to carry into effect the will of Congress as expressed by the statute".[10] Thus, a serious question is raised as to whether the SEC has the power to preempt validly adopted regulations of a sovereign state.[11]

The Public Statement cites the United States Supreme Court decision in *Sperry v. State of Florida*, 373 U.S. 379 (1963). The Committee, however, does not believe that the *Sperry* decision is apposite. In that case, the State of Florida obtained an injunction against a person who prepared and prosecuted patent applications before the U.S. Patent Office.

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[8] *See, e.g., Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990) (vacating SEC Rule 19c-4).

[9] This is particularly evident when Section 307 of the Sarbanes-Oxley Act is compared to Section 301 of the Private Securities Litigation Reform Act. The latter provision (Section 10A(b)(4) of the Securities Exchange Act of 1934) specifically requires a registered public accounting firm to report to the SEC in specific circumstances. While the Sarbanes-Oxley Act established a comprehensive regulatory scheme for that segment of the accounting profession that deals with issuers, the grant of authority to the SEC under Section 307 was limited to "setting forth minimum standards" for attorneys practicing before it. The Committee believes that the references in Section 307 to "public interest" and "protection of investors" are simply too general to evidence any actual intent by Congress to empower the SEC to adopt rules allowing attorneys to divulge client confidences and establish immunity for those who do.

[10] *Manhattan General Equipment Co. v. Commissioner*, 297 U.S. 129, 134 (1936). *See also Ernst & Ernst v. Hochfelder*, 424 U.S. 185 (1976).

[11] *La. Pub. Serv. Comm'n v. F.C.C.*, 476 U.S. 355, 374 (1986).

Florida had argued that the person was engaged in the unauthorized practice of law. Although the Supreme Court did vacate the injunction, the case differs from the SEC's actions in several material respects. First, the power of Congress to establish a patent office is expressly set forth in the United States Constitution.[12] Second, Congress expressly granted the Commissioner of Patents the authority to prescribe regulations, among other things, recognizing agents or other persons before the Patent Office.[13] Third, the practice by lay patent agents was long-standing at the time that Congress considered the statute.

The Committee believes that the SEC's rules present substantially different circumstances. The rules do not emanate from authority expressly vested in Congress by the U.S. Constitution. The statutory authority cited by the SEC, moreover, evidences no clear intent by Congress to supercede state laws and ethical rules. Finally, the SEC's rules represent a radical change from historical patterns of state regulation of attorneys. "When Congress remains silent regarding the preemptive effect of its legislation on state laws it knows to be in existence at the time of such legislation's passing, Congress has failed to evince the requisite clear and manifest purpose to supersede those state laws".[14] The United States Supreme Court has made the same point in the context of federalizing corporate laws:

> Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden.[15]

Indeed, upholding the SEC's "advance into an area not contemplated by Congress would circumvent the legislative process that is virtually the sole protection for state interests."[16]

The Public Statement also asserts that states must defer to the SEC's construction of good faith in determining whether an attorney will be subject to discipline or liability. However, the Committee expects that in specific cases, the question of whether an attorney acted in good faith will involve a determination of questions of fact as well as law. It is unclear to the Committee whether the SEC contemplates that it will make these factual findings in each case of voluntary disclosure by an attorney. In the absence of any SEC determination that the attorney acted in good faith, no conflict exists with a state determination.

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[12] Art. I, § 8 cl. 8 ("The Congress shall have the power . . . To promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries").
[13] 25 U.S.C. § 31 (subsequently repealed).
[14] *Pennsylvania Medical Soc'y v. Marconis*, 942 F.2d 842, 844 (3d Cir. 1991) *citing California Fed. Savings & Loan Ass'n v. Guerra*, 479 U.S. 272 (1997).
[15] *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 479 (1977).
[16] *Supra* note 8 at 419.

The Administrative Procedure Act requires a reviewing court to hold unlawful and set aside any agency action that is in excess of its authority.[17] As discussed above, there does not appear to be any evidence that Congress intended to delegate to the SEC the authority to promulgate Rules 205.3(d) or 205.6(c). Nor does there appear to be any evidence of Congressional intent to grant the SEC authority to preempt state disciplinary and liability rules. Given the fact that legitimate questions exist regarding the SEC's authority, the Committee believes that an attorney's paramount duties to his or her client require more than the assertion by an administrative agency that it is permissible to divulge client confidences.

5. The California State Bar has no Power to Refuse to Enforce State Statutes on the Basis of Federal Preemption unless an Appellate Court has so Ruled.

Article III, Section 3.5 of the California Constitution limits the authority of administrative agencies to refuse to enforce state statutes on the basis of federal preemption:

> An administrative agency, including an administrative agency created by the Constitution or an initiative statute, has no power . . . (c) To declare a statute unenforceable, or to refuse to enforce a statute on the basis that federal law or federal regulations prohibit the enforcement of such statute unless an appellate court has made a determination that the enforcement of such statute is prohibited by federal law or federal regulations.

Accordingly, the State Bar of California is not permitted to refuse to enforce Section 6068(e) on the basis of the assertion of federal preemption by a federal administrative agency. It may not even do so based upon a final order or judgment of a trial court, but must defer doing so even then until the order or judgment has been affirmed by an appellate court. In any event, the Committee believes that for the reasons set forth above, substantial questions exist concerning the SEC's authority to preempt state law.

6. Conclusion.

In summary, well-established public policy supports California's rules protecting client confidences. The Committee believes that California attorneys will expose themselves and their clients to substantial risks if they disclose client confidences in reliance upon the SEC's rules and in violation of California law. The Committee further believes that the California State Bar has no power to declare a state statute unenforceable unless and until an appellate court so rules. Finally, the Committee believes the SEC's authority to adopt these rules is untested and may be successfully challenged. Accordingly, the Committee respectfully requests that the SEC reconsider its position as set forth in the Public Statement.

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Please note that positions set forth in this letter are only those of the Committee. As such, they have not been adopted by the State Bar's Board of Governors, its overall

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[17] 5 U.S.C. § 706.

membership, or the overall membership of the Business Law Section, and are not to be construed as representing the position of the State Bar of California. The Committee is composed of attorneys regularly advising California corporations and out-of-state corporations transacting business in California. **Membership in the Business Law Section, and on the Committee, is voluntary and funding for activities of them, including all legislative activities, is obtained entirely from voluntary sources. There are currently more than 9,500 members of the Business Law Section.**

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The State Bar of California Business Law Section
Corporations Committee Members

As of the date of this letter, the Corporations Committee is composed of the members shown below, not all of who necessarily endorse each and every recommendation and view expressed in this letter. Taken as a whole, however, this letter reflects a consensus of the members of the Corporations Committee.

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